

# Foresights from Foresters Asset Management.

## Fixed income Mid-Year Update



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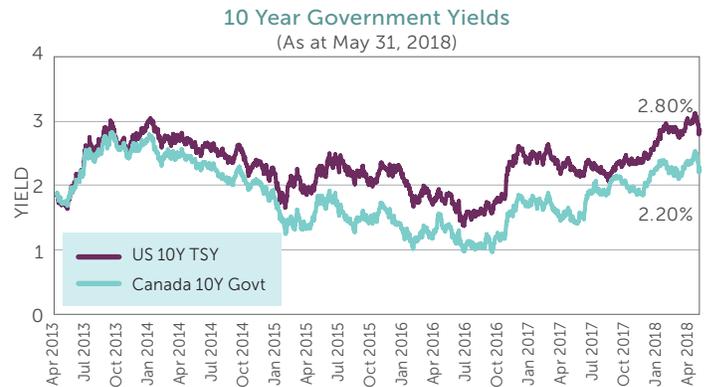
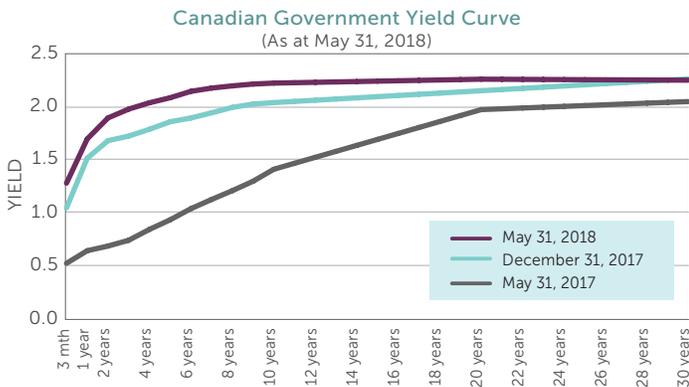


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### Summary

- Fixed income credit markets have seen heightened volatility in the past few months.
- Volatility creates opportunities. Foresters Asset Management (“FAM”) has taken advantage of recent bouts to upgrade the quality of the portfolios.
- Recent inversion of Canadian yield curve is not as worrisome as it appears.
- The pace of Canada/U.S. rate hikes is a tale of two cities.
- FAM still sees no major stress in the credit markets.

### Market Overview



In the past few months, fixed income credit markets have seen heightened volatility. This turbulence, in FAM’s view, is actually a by-product of volatility in equity markets, which is being driven by key geopolitical risks. The market is grappling with uncertainty related to ongoing NAFTA negotiations, trade friction between the U.S. and China, as well as the fate of talks aimed at denuclearizing the Korean peninsula.

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Volatility creates opportunities. As such, we have been seizing these opportunities to upgrade our fixed income portfolios as favourable circumstances arise. This has meant taking profits on existing positions and de-risking, as appropriate. All in all, our approach at this time is informed by our sense that we are late in the credit cycle. There are times to be bulls on credit and times to be bears. When we're very bullish, we may take our exposure to close to 90%. At our most bearish, we typically target 70% exposure. Lately we've been between the middle of this range and somewhat lower. We actually aren't global credit bears for 2018. That said, when you're late in the cycle, it's prudent to take defensive measures shortly before the peak.

It's notable that the yield curve has flattened in the last three months (and, as we discuss, briefly inverted). Interestingly, the credit curve has not widened, despite this flattening of the risk-free rate curve. Therefore, if the government curve were to steepen again, we do not expect a similar flattening effect of the credit curve. We think spreads will tend to be range bound to slightly wider from these levels, depending on the geopolitical tone in the market.

## Recent Inversion of Canadian Yield Curve: Not as Worrisome as it Appears

On May 17, the Canadian 10s-30s yield curve inverted for a brief period. The curve is now +1 bps, but 15s-30s are inverted. This is the first inverted curve in North America during this credit cycle, and obviously might make some investors nervous. Importantly though, there's reason to believe the current inversion can't be directly compared to the curve inversion of 2007. For one thing, it's worth noting that 10s-30s is not really a macro curve. Rather, it depends more upon fund flows and the duration needs of portfolios versus macro economic events and interest rate hikes. With regards to fund flows, we are expecting an index extension of almost +19 bps on June 1, when some of the shorter dated bonds

are scheduled to come out of the index. Bond futures are being used by market participants to preempt this move, which is exacerbating the flattening trend.

On a longer-term horizon, there is a natural bid for 30-year and longer Canada bonds from pension funds and insurance companies, this is to match their liabilities to assets and this bid is expected to continue. From a macro standpoint, if the market was expecting an imminent slowdown or possible recession, the natural curve to invert would be 2s-30s, not 10s-30s. The 2s-30s curve is at +47 bps in Canada vs +65 bps in the U.S. , which is still relatively steep.

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## The Pace of Canada/U.S. Rate Hikes is a Tale of Two Cities

Both the U.S. and Canada are currently raising benchmark policy rates. But while they're heading in the same direction, the pace of hikes for the remainder of the year should be markedly different. Here, in Canada, we may only get one more hike in 2018 (perhaps in July). Bank of Canada Governor Stephen Poloz has repeatedly mentioned the related issues of high consumer debt levels and elevated house prices. Clearly, he is wary of raising rates too quickly due, in part, to these factors. Moreover, we suspect the central bank wants to see the full effects of stricter mortgage rule changes, that were introduced in January, and previous rate hikes, before tightening much further.

Contrast the situation in Canada with that in the U.S., south of the border, the economy is much stronger and household balance sheets aren't nearly as stretched. The end result is that we may see the Fed raise rates three more times in 2018, once in

each quarter. This has implications for fixed income strategies. In the U.S, we see greater opportunities in shorter durations, given the likelihood that the long end has not fully priced in these three Fed rate hikes. By comparison, seeing as it's unlikely the Bank of Canada will hike more than once this year, the long end of the curve should be more insulated from central bank hawkishness.

From a global perspective, the situation in Europe is worth mentioning. Last year, both economic growth and inflation picked up, raising expectations that the ECB would wind down its QE program later this year. However, both growth and inflation have disappointed, as of late. Furthermore, political uncertainty in Europe is adding another layer of concern to the markets. We would not be at all surprised if the ECB opts to stay on the sidelines for an extended period of time, due to these developments.

## Still No Major Stress in Credit Markets

In the U.S., there are still strong bids for credit from underfunded pension funds who are moving from equities to fixed income. Their bids, plus the flattening of the yield curve, is supportive for credit, overall. For these reasons, we are reasonably constructive on credit for the remainder of the year, even though we think 2019 could be more challenging. As it stands currently, some high yield names are having a bit of trouble, but there has not been a significant rise in defaults for that segment of the market generally. Our portfolios hold investment grade issues, so we aren't directly exposed to high yield, but it's something we regularly monitor as a barometer of risk appetite for credit.

From the supply perspective we are anticipating overall issuance for 2018 to be between \$95-100 billion CAD. The primary driver of this supply will come from Canadian banks which have already prefunded a significant portion of their maturities, having been absent from the Canadian market for the best part of 2017, due to favourable funding levels globally. We expect spreads to marginally weaken but stay within a narrow range.

When we look back at our outlook from December 2017, time is the only variable that has really changed. Back then, we envisioned a flattening and possible inversion of the yield curve for the year. As markets have evolved, flattening has definitely occurred but the front end of the yield curve is still relatively steep and we don't expect it to invert until late 2018 to early 2019. Much of this will depend upon the Fed's pace of interest rate increases, in reaction to firming inflation numbers. An overly aggressive Fed could over tighten, leading to a curve inversion and the economy falling into a recession. Recent comments from Federal Open Market Committee ("FOMC") members suggest that they are quite conscious of such a potential outcome. Our expectation is that they will be careful of taking any action which might derail the economic momentum. We are keeping a close eye on these developments and continue to reposition our portfolios accordingly.

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